No. 14594

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

JACK SMITH and ROSE MAE SMITH,

Appellants,

vs.

HARRY C. WESTOVER, former Collector of Internal Revenue, and ROBERT A. RIDDELL, Director of Internal Revenue,

Appellees.

APPELLANTS' REPLY BRIEF.

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I.

Appellees Have Completely Failed to Meet Appellants' Contention That the Facts as Found by the Trial Court and Upon Which the Trial Court's Judgment Was Founded Are Basically Erroneous.

The appellants believes that here, as is true of most controversies, if the facts involved are truly understood the determination of the law applicable becomes relatively simple.

Accordingly, appellants, in their opening brief, in the utmost good faith undertook to state carefully and accurately the basic facts of this contvoresy. Each statement made was carefully buttressed by exact references to the record.

It is unfortunate that appellees in their brief do not even attempt to answer the bulk of appellants' statements with respect to the facts involved. Instead, appellees accept without question the facts as found by the trial court in its memorandum decision and findings of fact. Appellees apparently believe that constant repetition of a statement converts error into truth.

We earnestly request that this Court determine the facts involved upon its own account and refer to the record as documented in the "Statement of Facts" in appellants' opening brief beginning on page 5.

While no useful purpose will be served by restating the trial court's errors as compounded by appellees, a few of these basic mistakes may well be referred to.

(1) *Appellees have completely ignored appellants' repeated reference to the fact that we are here dealing with two separate and distinct partnerships.*

Any alleged weakness in the first partnership agreement is imputed to both. The flatness with which this is done is difficult to understand or explain.

For example, appellees say (Br. p. 4):

> "The partnership could not conduct business transactions, enter into any contract or incur any liability during his lifetime (Jack Smith) and continuance as a partner without his approval and consent, and no amendment of the partnership could be made without his consent."

The above statements are deemed important by appellees so far as the problem of control is concerned. Appellees assert that the above facts existed throughout the period with which we are involved which includes two

partnerships. This is true despite appellants' repeated statements that regardless of what might have been the situation with regard to the first partnership, the second partnership agreement provided to the exact contrary.

(2) *Appellees compound their error by stating* (Br. p. 4), *"he had the power to terminate the partnership interests and to purchase the partnership at book value."*

As appellants carefully pointed out in their opening brief this statement, while again of importance so far as control is concerned, is directly contrary to the facts as disclosed by the record. Under neither partnership could Jack Smith terminate the partnership and purchase the assets at book value. With respect to both partnerships all the partners had the same right and such right arose only as to the interest of a withdrawing or deceased partner.

(3) *Appellees state* (Br. p. 5), *"the main partners, the taxpayers here, retained the power to determine the amount of salaries to be paid themselves * * *." Such a statement is not only completely incorrect factually but discloses a confused approach to the entire problem.*

As appellants have heretofore pointed out in their opening brief salaries were fixed by the vote of the partners. Further, the use of the word "retained" is obviously misleading. Prior to the formation of the partnership Appellant Jack Smith was operating a sole proprietorship consisting of his separate property. As such he paid himself no salary. At the same time Appellant Rose Smith had separate property consisting of the obligations of Jack Smith. She obviously paid herself no salary.

As has been repeatedly indicated the fact that salaries were paid to the active partners based on the worth of the services performed by each has, except in this controversy, been deemed an element of strength instead of weakness.

This Court may be very certain that in this case if the partners, other than the Trusts, had drawn no salary, appellees would have pointed out that fact in no uncertain terms and claimed that it demonstrated lack of reality.

(4) *Appellees state in their brief on a number of occasions that "No part of the income, the taxability of which is here in issue, has ever been distributed to or subjected to the control of the taxpayers' children."*

Here again is an example of appellees' clouded thinking. The Trusts specifically provided that income should be accumulated until the beneficiaries attained 21. Thereafter, and until 25, income was distributable at the discretion of the trustee. Beginning at age 25 corpus and undistributed income was to be paid over to the beneficiaries at five-year intervals until exhausted.

At the time of the trial of this proceeding neither beneficiary had attained 25. The trial court complimented appellants for their generosity in supporting the children regardless of the fact that they could have drawn for their support upon the Trust. Appellees thus become critical of a course of conduct praised by the trial court.

(5) *Repeatedly appellees urge that no "fresh capital" was contributed by the Trusts. Here again appellees ignore the plain facts involved.*

Nine months before the first partnership was formed appellants divided their community property as evidenced by their investment in the Boston Shoe Company because

of a disagreement as to business policies. Appellant Rose Smith received bona fide notes of Jack Smith totalling over $100,000.

The partnership eventually formed was not contemplated when the community property was divided. The appellants originally considered providing for their children by gifts which would be invested in income real estate.

When the first partnership was formed, Mrs Smith contributed as her share $60,000 of her husband's notes which were her separate property. This was certainly fresh capital so far as she was concerned. One of the Trusts made as its contribution to the partnership capital a $30,000 note of Appellant Jack Smith, obtained through Mrs. Smith. This was certainly fresh capital in the sense that it was not theretofore employed in Jack Smith's business.

The second Trust contributed to the partnership $30,000 in government bonds obtained from Jack Smith by means of a bona fide gift. Said bonds had not been employed in appellants' business except as a base for credit.

It must be borne in mind that Appellant Jack Smith testified without equivocation that one of the reasons he wanted Mrs. Smith back in the business was to eliminate the note liability which restricted his credit and area of expansion.

Further, and what is of particular importance and which constitutes a point missed completely by appellees is the fact that we do not have here a split up of a going business with no change whatsoever in assets or liabilities.

II.

Appellees Have Likewise Failed to Meet Appellants' Contention That the Trial Court Misconstrued the Law Here Applicable.

Appellees instead of considering specifically appellants' enumeration of the errors committed by the trial court in applying the law to this proceeding have indulged in generalities constituting mixed allegations of fact and law.

(1) *Appellees make much of the contention that here there was no contribution of capital by the Trusts.*

We have heretofore pointed out that in our judgment this statement is totally without merit both as a matter of fact and law.

Appellees apparently urge that if the owner of a going business withdraws cash or securities from his investment portfolio, gives these to a relative and that relative invests these securities or the cash obtained therefrom in a new enterprise with the donor that no fresh capital has entered the business.

It is respectfully submitted that such is not the law.

This very point was considered by this Court in *Snyder v. Westover*, 217 F. 2d 928 (1954).

There the taxpayer entered into a written partnership agreement with his children, giving each child a 25% interest in the partnership evaluated at $2,500.

The Commissioner urged that this did not constitute a capital contribution of the child. This Court disposed of that contention in the following language:

> "This $2,500 represents a one-fourth interest in the partnership, and was given to Geraldine by plaintiff

at the time of the partnership agreement. Appellee argues that since the $2,500 had its 'genesis in her father's largess' it cannot be considered a capital contribution of her own. The mere fact that the contribution of the daughter originated with the father is not conclusive."

(2) *Appellees argue that there was no rendition of vital services.*

This is, of course, true so far as the children were concerned since they were both admittedly minors during the years in question.

The basic fallacy of appellees argument, however, lies in the bland assumption that the appellants in the capacity of trustees could not and did not render vital services to the partnership.

As will hereinafter be pointed out we have again the failure on the part of the appellees to give any weight, legal or otherwise, to the Trusts with which we are here concerned.

(3) *Appellees urge that there was no participation in management and control.*

In their brief (p. 16) appellees quote from a colloquy between the trial court and the Appellant Jack Smith:

> "The Court: You never took a vote with your wife or children to decide by a majority vote what you were going to do?"

The question misses the point. Of course, the vote of the children was not taken. The children were beneficiaries of irrevocable trusts. They had no right nor power to direct the conduct of the trustees and it was never contemplated that they should have such right.

Apparently the trial court would not have objected to such lack of power on the part of the children had the trustees been court appointed. Because they were voluntary *inter vivos* trustees, however, the instrument under which they functioned became a worthless bit of paper.

(4) *Appellees urge that there was "no business purpose for including the Trusts as partners."*

Assuming that any such business purpose is necessary, we respectfully submit that it here existed. As has been heretofore pointed out when Appellant Jack Smith divided his community property with his wife bona fide liabilities to the extent of more than $100,000 were created. These liabilities, which showed in his financial statements, affected his credit and limited expansion.

Business judgment called for the elimination of this liability from Jack Smith's operating statement.

Exactly the same situation existed with respect to the obligation of appellant contributed by one of the Trusts. The moment this obligation ceased to exist appellant's credit base was increased.

While a somewhat different situation may have existed with respect to the $30,000 in bonds contributed by the second Trust there is certainly no rule of law which requires a business purpose with respect to each and every partner in a partnership.

The fact is that the partnership when formed was a different and stronger business entity than had theretofore existed considering the various partners separately.

(5) *The appellees urge that everything which was here done was motivated by tax saving consideration.*

First, there is no evidence in the record upon which any such assertion can be based. In fact the available evidence is exactly to the contrary.

Appellees urge with considerable warmth that because the gifts made to the Trusts were within the gift tax exemptions and exclusions that a general tax plan is evidenced.

Presumably if $31,000 had been given by Appellant Jack Smith to one of the trusts instead of $30,000 we would have had no problem. To state such an assertion is to disprove it.

(6) *Finally, appellees urge that there was no real change in the economic status of the family.*

This statement is totally without merit both as a matter of fact and of law. We have heretofore pointed out the facts involved, outlined the division of the community property by the appellants, followed by the reinvestment of said property including property received by the Trusts as gifts in a new enterprise *to which additional capital was contributed and with respect to which an enlarged business was carried on.*

The exhibits attached to the record, the statements of the trial court, and the other available evidence indicates conclusively that each of the parties maintained his financial independence and interest in the new enterprise.

Appellees urge, however, that because the Trusts agreed to pay to the appellants a certain portion of the extra taxes which appellants have been compelled to pay as a

result of appellees' attack upon the partnership that thi evidences lack of economic reality.

Appellees, however, failed to properly inform the cour as to the nature of the agreement in question [R. 268 272]. Said agreement between the trusts and the appel lants provides that in the event the appellants are com pelled to pay additional taxes because of the inclusion i appellants' income of the Trusts' share of partnershi income then the Trusts would pay to the appellant amounts equal to the tax due from the Trusts at the rate applicable to said trusts.

The agreement was not, as appellees assert, that th Trusts would bear "the burden of additional taxes to b imposed against them (appellants) individually."

The agreement simply meant that the Trusts would no profit by appellees' erroneous actions in this proceeding

The Trusts paid their own individual taxes during th years in question. When the appellees added the incom in question to appellants' income appellants were require to pay a tax at a much higher rate than would be du from the Trusts.

When the appellants paid the taxes here in controvers appellees refunded to the Trusts the taxes theretofore pai by them.

If the Trusts kept this refund they escaped completel tax free, thus making a profit equal to the amount of ta which they thought was due from them on account of th income received by them from the partnerships.

The agreement in question merely provided that in th event of such payment by appellants that the Trusts woul pay to the appellants the tax legitimately due from sai Trusts. The result was to leave the Trusts in exactl

the same position as if the appellees had not attacked the validity of the partnerships. The Trusts made no profit and suffered no loss.

Despite this obviously equitable approach appellees assert that this agreement proves that the Trust assets "are readily accessible to the taxpayers and they may with the same facility with which they dipped into them to pay for personal tax liabilities resort to such assets for other purposes." We respectfully submit that such a statement ignores realities, is without foundation in the record and made with questionable propriety. As a matter of fact, appellees' assertion demonstrates again the basically erroneous attitude of the trial court and appellees toward the Trusts in question.

It must be obvious that a trustee whether court appointed or otherwise can make mistakes. In both cases the trustee, when discovered, must respond to the wronged beneficiary. The rights of the beneficiary to proceed against the trustee for wrongful conduct are identical in both cases. This basic premise was pointed out by appellants in their opening brief on a number of occasions. Appellees, however, never made the slightest effort in their brief to answer in any respect this important contention. Instead they fall back upon the trial court's findings of fact, memorandum decision, and conclusions of law.

Again it is respectfully urged that the judgment of the trial court was clearly erroneous and should be reversed.

Respectfully submitted,

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Dated: April 15, 1955.